+RZ WR $YRLG
5HYHQX

&3((GLWLRQ

'LVWULEXWHG E\ $FFRXQWLQJ7RROV ,QF

ZZZDFFRXQWLQJWRROV F

How to Audit Revenue

Steven M. Bragg

Copyright © 2021 by AccountingTools, Inc. All rights reserved.

Published by AccountingTools, Inc., Centennial, Colorado.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the Publisher. Requests to the Publisher for permission should be addressed to Steven M. Bragg, 6727 E. Fremont Place, Centennial, CO 80112.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For more information about AccountingTools® products, visit our Web site at www.accountingtools.com.

Course Information

Course Title: How to Audit Revenue

Learning Objectives:

- Recognize the various accounts that comprise an organization's revenue.
- Describe the different types of revenue fraud arrangements.
- Identify the methods used by an auditor to audit revenue.
- Identify the circumstances under which a contract does and does not exist.
- Recognize the steps used in the revenue recognition process.
- Describe how and when the expected value method is used.
- Recognize the accounting rules that apply to noncash assets, nonrefundable fees, and customer acceptance.

Subject Area: Auditing

Prerequisites: None

Program Level: Overview

Program Content: This course clarifies for the auditor every action needed to audit revenue. It describes the characteristics of revenue from an auditing perspective, and then goes on to describe the steps required to audit revenue. Background information concerning revenue recognition is also included, such revenue recognition rules, consignment arrangements, customer acceptance issues, revenue fraud, and revenue controls.

Advance Preparation: None

Course Expiration Date: This course expires one year from the date of purchase.

Publication/Revision Date: May 2021

Recommended CPE Credit: 2 hours

Table of Contents

Chapter 1 - Auditing Revenue **1**

Auditor Objectives *1*

Background Research *1*

Auditing Characteristics of Revenue *2*

Characteristics of Revenue Accounts *2*
Revenue Accounts 2
Sales Returns and Allowances 3

Revenue Process Flow *3*

Revenue Fraud Schemes *4*
Accelerated Revenue Recognition 4
False Sales 4
Bill and Hold Transactions 5
Delayed Sales Deductions 5

Auditing Activities *5*
Inherent Risk Assessment 5
Material Misstatement Assessment 5
Substantive Procedures 6

Examine Sales Cutoff *7*

Verify that Invoices are Correct *8*

Verify that Sales Transactions are Properly Recorded *8*

Examine Supporting Documentation *8*

Examine Multi-Component Sales *9*

Review Customer Contracts *9*

Review Changes in Accounting Policies *9*

Evaluate Business Purpose *9*

Review Accrued Revenue *9*

Review Consignment Transactions *10*

Examine Sales Returns *10*

Examine Sales Returns Allowance *10*

Test for Intercompany Sales *10*

Verify Cancellation of Shipping Documents *11*

Verify Segregation of Duties *11*

Search for Related Parties *11*

Confirm the Absence of Side Agreements *11*

Conduct Analytical Procedures *11*

Review Presentation *12*

Internal Controls Used by the Client *13*

Advance Work *14*

Review Questions ... *15*

Chapter 2 - Revenue Rules ... **16**

Topic 606, Revenue from Contracts with Customers ... *16*

Steps in Revenue Recognition ... *16*

Step One: Link Contract to Customer ... *17*

Step Two: Note Performance Obligations ... *17*

Step Three: Determine Prices ... *19*
Variable Consideration ... 19
Possibility of Reversal ... 19
Time Value of Money ... 20
Noncash Consideration ... 20

Step Four: Allocate Prices to Obligations ... *21*
Allocation of Price Discounts ... 22
Allocation of Variable Consideration ... 22
Subsequent Price Changes ... 22

Step Five: Recognize Revenue ... *23*
Measurement of Progress Completion ... 23
Output Methods ... 24
Input Methods ... 24
Progress Measurement ... 24
Right of Return ... 25

Bill and Hold Arrangements ... *25*

Consignment Arrangements ... *26*

Customer Acceptance ... *26*

Nonrefundable Upfront Fees ... *26*

Principal versus Agent ... *27*

Review Questions ... *29*

Answers to Chapter Questions ... **30**

Glossary ... **32**

Index ... **33**

Final Examination ... **34**

About the Author

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been a two-time president of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado. He has written more than 250 books and courses, including *New Controller Guidebook*, *GAAP Guidebook*, and *Payroll Management*.

Steven maintains the accountingtools.com web site, which contains continuing professional education courses, the Accounting Best Practices podcast, and thousands of articles on accounting subjects.

Buy Additional AccountingTools Courses

AccountingTools offers more than 1,200 hours of CPE courses, with concentrations in accounting, auditing, finance, taxation, and ethics. Related courses that you might like include:

- Fraud Examination
- Fraud Schemes
- Revenue Management
- Revenue Recognition

Go to accountingtools.com/cpe to view these additional courses.

Chapter 1
Auditing Revenue

Learning Objectives

- Recognize the various accounts that comprise an organization's revenue.
- Describe the different types of revenue fraud arrangements.
- Identify the methods used by an auditor to audit revenue.

Introduction

Revenue is the volume of goods or services sold by a business during a reporting period, and is reported at the top of the income statement. This is one of the most critical line items in an organization's financial statements, and so is of great concern to the auditor. In this course, we examine the characteristics of revenue from an auditing perspective, and then note the auditing activities that can be applied to the revenue area. We also summarize the essential accounting rules for revenue, including steps in the revenue recognition process, bill and hold arrangements, consignments, and customer acceptance criteria.

Auditor Objectives

When developing an audit program for revenue, the auditor must consider his or her objectives in this area. They are as follows:

- To discern the internal controls over revenue.
- To consider the inherent risks associated with revenue.
- To gauge the risk of material misstatement.

Based on these objectives, the auditor must develop an audit program that contains adequate tests of the client's substantive procedures and controls that are targeted at the following:

- *Accuracy*. Affirm that recorded sales are accurate.
- *Classification*. Demonstrate that sales have been correctly classified.
- *Completeness of records*. Verify that the sales stated in the client's records have been fully recorded.
- *Cutoff*. Prove that the transactions triggering the recordation of revenue are recorded in the correct period.
- *Disclosure*. Corroborate that the information about revenue in the client's financial statements is properly presented and fully disclosed.
- *Valuation*. Certify that the valuations of the recorded sales are correct.

Background Research

Revenue is the largest single line item on the income statement, so the auditor should acquire a deep understanding of how a client generates sales. This can involve understanding the following:

- Client policies related to the extension of credit, pricing, payment terms, and the acceptance of sales returns.
- The different types of customers to which the client sells.
- The distribution channels through which products and services are sold.

- The extent of sales returns in comparison to different types of sales.
- The extent to which discounts and other allowances are used to obtain sales.
- The extent to which salesperson compensation plans are used to drive sales.
- The extent to which seasonality alters sales over the course of a year.
- The extent to which the client is subject to cyclical changes in sales.
- The revenue recognition practices within the industry, and how the client's practices vary from the industry standard.
- The types of products and services sold.

Auditing Characteristics of Revenue

There are several general characteristics of revenue that can impact the contents of the audit plan. These characteristics are:

- *Fraud risk*. When a client wants to inflate its financial results, a common way to do so is through the false or improper recordation of revenue. Thus, there can be a risk of material misstatement due to fraud in this area.
- *Missing billings*. If there is a breakdown in the notification system between the shipping department and the accounting department, it is possible that customers will not be billed at all, even though goods have been shipped.
- *Complex transactions*. Some sales transactions involve multiple elements or unusual terms, which may lead to incorrect revenue recognition. This problem is especially common when sales contracts have not been standardized, as well as when sales transactions involve a mix of goods and services.
- *Impact of cutoff issues*. A client may attempt to keep its books open past the end of its fiscal year-end, so that it can artificially boost its sales by adding on a few more shipments. Inadequate procedures and controls can also lead to this outcome.

These characteristics reveal that there are several risks related to revenue for which auditors need to prepare. When there are weaknesses in a client's system of internal controls, *all* of these characteristics may be present, which will call for a more expansive set of audit procedures.

Characteristics of Revenue Accounts

When auditing revenue, the auditor will need to recognize which client accounts roll up into the total revenue figure. Sales accounts summarize into the gross sales figure, while sales returns and allowances reduce these sales to arrive at the net sales figure. These accounts are described in the following sub-sections.

Revenue Accounts

An organization can generate many kinds of revenue, so it makes sense to record them within different accounts. This is done in order to generate reports that aggregate revenue by type, for further management analysis. The accounts in which revenue transactions can be recorded depend upon the nature of the underlying transactions. For example:

- *Product sales*. This account is used by companies that sell goods to their customers, such as automobiles or consumer electronics. This type of revenue is typically billed based on a flat fee per unit shipped.
- *Service sales*. This account is used by organizations that provide services to their customers, such as consulting services or tax advice. This type of revenue is typically billed on an hourly basis to customers, or is a fixed fee in exchange for services (such as a $100 flat fee to repair a washing machine).

Revenue accounts may be subdivided in many ways. For example, service sales could be stored in separate accounts for each regional office of a consulting firm, and then aggregated into a single service sales line item for the entire company. Alternatively, product sales could be stored in separate accounts for each product, and then aggregated into a single product sales line item for the entire company.

Revenues may also be earned from activities that do not relate directly to operations. These earnings are typically stored in separate accounts, such as:

- Interest income
- Dividend income
- Rent income

These non-operating revenue accounts may be stated lower in the income statement, to keep them from being confused with the main operating revenue accounts.

Sales Returns and Allowances

Sales returns and allowances is a line item appearing in the income statement. This line item is presented as a subtraction from the gross revenue line item, and is intended to reduce sales by the amount of product returns from customers and sales allowances granted. It is followed in the income statement by a net sales line item, which is a calculation that adds together the gross sales line item and the negative amount in the sales returns and allowances line item.

This line item is the aggregation of two general ledger accounts, which are the sales returns account and the sales allowances account. Both of these accounts are contra accounts, which means that they offset gross revenues. The natural balance in these accounts is a debit, which is the reverse of the natural credit balance in the gross sales account.

The two accounts may sometimes be combined into a single account in the general ledger. This typically happens when the balances in these accounts are relatively small, so there is no point in tracking returns and allowances separately.

Revenue Process Flow

Before delving into auditing activities, we include a brief summary of the process by which revenue is created. The process begins when a customer issues a purchase order to the client, specifying the nature of the goods or services it wants and the prices it will pay. The client may translate the information on the purchase order into an internal document known as a sales order. A sales order is used to standardize the information needed to process customer orders. Once a sales order has been created, there are two possible routings. Under one option, if the customer has already paid or will do so upon receipt of the goods, the sales order is routed to the warehouse, which picks the goods from the shelf and ships them to the customer. Under a second option, if the client is extending credit to the customer, the sales order is first routed through the credit department, which decides whether credit should be extended to the customer and the payment terms that will be enforced.

When goods are being shipped, a bill of lading is prepared, where one copy is enclosed with the delivery and another copy is sent to the accounting department. The billing clerk in the accounting department matches this bill of lading to the department's copy of the sales order, and uses this information to prepare an invoice. If the customer already paid, then the invoice is marked as paid in full. Otherwise, it is prepared with the payment terms specified by the credit department. Once the invoice has been prepared in the accounting system, the software automatically posts the invoiced amounts to the sales ledger, which creates revenue in the general ledger.

If a customer returns a product, the accounting department prepares a credit memo that records a reduction in the amount billed to the customer, thereby negating the amount of the sale related to the item that was returned by the customer.

Revenue Fraud Schemes

Employees can perpetrate several fraud schemes involving revenue, usually with the intent of inflating revenues in order to give the users of a firm's financial statements an excessively optimistic opinion of sales levels and the sales trend. The manipulation of revenue is a particular problem, because revenue is usually the largest account in the income statement, so even a relatively minor misstatement representing a small percentage of sales can still have a notable effect on income. Further, a false increase in revenue typically passes straight through to income, since there is no cost of sales associated with a fictitious increase in revenue. In the following sub-sections, we note several fraud schemes that involve revenue.

Accelerated Revenue Recognition

A firm may be tempted to recognize a sale for a legitimate sales transaction, but which should not be recognized until a later period, when performance has been completed. For example, a customer sends in $10,000 along with an order, which is immediately recognized as revenue – even though no work has been done to complete the order. As another example, a sale transaction may be contingent on an event that will not occur until a later date – such as customer acceptance of an installed system – but the client decides to recognize the revenue at once, despite the existence of this contingency. The simplest form of accelerated revenue recognition is when the accounting records are kept open past the end of a reporting period, so that sales for the following period are recorded in the prior period instead. A less-common variation is to ship goods sooner than customers have asked for them, in situations where customers have requested delivery in a later period.

The best way to detect accelerated revenue recognition is to examine a selection of sales transactions to determine whether a sale transaction has actually been completed in accordance with the accounting rules (see the next chapter). However, a client can use a highly complex transaction to intentionally muddle the timing of revenue recognition, making fraud difficult to detect.

False Sales

A perpetrator can create fake transactions to generate entirely false sales. For example, someone could create an order from a fake customer, enter it into the company's order entry system, and even support the resulting invoice with falsified records that show the delivery of goods or services to the "customer." Another approach is to enter into a side agreement with a customer, under which the customer agrees to buy a certain amount of goods and services so that the client can generate billing documentation, after which the client buys back some or all of the goods or services, perhaps at an inflated price. Another type of false sale arises when goods are shipped under a consignment arrangement, where the shipper continues to own the shipped goods until they are eventually sold by the receiving party. The shipper could characterize these shipments as sales, even though it may continue to own the inventory for a protracted period of time. Another type of false sale is to ship goods that were never ordered by a customer, or by billing goods at prices higher than those to which the customer originally agreed. Finally, a company could simply ship goods to another company location and issue invoices for the goods shipped.

False sales are difficult to support over a long period of time, since the related receivables are never collected, resulting in an ongoing increase in the days sales outstanding measurement. However, false sales can be effectively hidden if they are only needed once (such as to earn a year-end performance bonus), and are then written off in the following year by recognizing a bad debt.

An ongoing program of confirming sales with customers improves the odds of detecting false sales, unless the client creates a fake address for the "customer" that is controlled by an associate. This associate can then respond positively to any confirmations sent in regard to outstanding receivable balances.

Bill and Hold Transactions

A client may recognize revenue from a customer, despite still having the related goods on its premises. It uses as an excuse that the client and customer have entered into a bill and hold arrangement, where the customer accepts ownership of the goods but requests that the client hold the goods for a certain period of time, essentially acting as a storage facility for the customer. The accounting rules for bill and hold arrangements are quite specific, as noted in the following chapter. In many cases, alleged bill and hold transactions should not result in the recognition of revenue.

Delayed Sales Deductions

A business routinely issues credits to reduce its recorded sales level, based on product returns from customers. These returns can be hidden by delaying their processing into a later reporting period. The auditor can find these returns by conducting an analysis of processed returns in the months immediately following the client's year-end.

Auditing Activities

In this section, we provide an overview of the auditing activities associated with revenue, and follow up with more detail on selected auditing tasks in later sections.

Inherent Risk Assessment

The auditor should use his or her knowledge of the client to consider inherent risks related to revenue. Inherent risk is the probability of loss based on the nature of an organization's business, without any changes to the existing environment. The concept can be applied to the financial statements of an organization, where inherent risk is considered to be the risk of misstatement due to existing transactional errors or fraud. Inherent risk is considered to be more likely under the following circumstances:

- *Judgment*. A high degree of judgment is involved in business transactions, which introduces the risk that an inexperienced person is more likely to make an error.
- *Estimates*. Significant estimates must be included in transactions, which makes it more likely that an estimation error will be made.
- *Complexity*. The transactions in which a business engages are highly complex, and so are more likely to be completed or recorded incorrectly. Transactions are also more likely to be complex when there are several subsidiaries submitting information for inclusion in the financial statements.

Some of the preceding circumstances can be found in the accounting for revenue, so there is some inherent risk to consider. For example, some invoices can be quite complex, which increases the risk that the amounts billed to customers are incorrect, or that the related revenue recognition is incorrect.

Material Misstatement Assessment

As noted earlier, one of the objectives of the auditor is to gauge the risk of material misstatement. This assessment is largely based on tests of the client's controls over its revenues. Several possible misstatements are as follows:

- Duplicate sales, where two or more billings are made based on one delivery
- Sales made with no supporting customer shipments
- Sales to nonexistent customers, where the customer fraudulently prepares fake billing information

The risk of material misstatement can increase when a client engages in any of the following:

- Management pressures employees to increase sales and profits at a rapid pace
- The client allows its sales staff to create sales terms that differ significantly from its normal terms
- The client engages in barter transactions
- The client engages in unusually complex sale transactions that contain multiple elements
- The client has altered its baseline contractual arrangements with customers
- The client has altered its revenue recognition policy
- The client is selling new goods and services, which are dealt with using different sales arrangements than were used for its older goods and services
- The client routinely engages in bill and hold transactions (see the next chapter)

A sampling of client controls in this area appears near the end of this chapter. The auditor can examine the efficacy of those controls to decide whether any reliance can be placed on them when designing an audit plan.

The assessment of inherent risk and material misstatement by the auditor determines the extent of the substantive procedures related to revenue.

Substantive Procedures

Substantive procedures are intended to create evidence that an auditor assembles to support the assertion that there are no material misstatements in regard to the completeness, validity, and accuracy of the financial records of a client. Thus, substantive procedures are performed in order to detect whether there are any material misstatements in accounting transactions. Substantive procedures include the following general categories of activity:

- Testing classes of transactions, account balances, and disclosures
- Agreeing the financial statements and accompanying notes to the underlying accounting records
- Examining material journal entries and other adjustments made during the preparation of the financial statements

At a general level, substantive procedures related to testing transactions can include the following:

- Examining documentation indicating that a procedure was performed
- Re-performing a procedure to ensure that the procedure functions as planned
- Inquiring or observing regarding a transaction

The following are all considered to be substantive procedures. These items are explained more fully in the following sections of this chapter.

- *Examine sales cutoff*. Ensure that only shipments made within the reporting period are recorded as sales within that period.
- *Verify that invoices are correct*. Examine all elements of prepared invoices for accuracy.
- *Verify that sales transactions are properly recorded*. Verify that invoices have been correctly recorded in the accounting records.
- *Examine supporting documentation*. Verify that there is sufficient evidentiary matter to support each sale.
- *Examine multi-component sales*. Examine how revenue was calculated for each element of multi-component sales.
- *Review customer contracts*. Delve into the details of any unusual terms included in the client's contracts with customers.

- *Review changes in accounting policies*. Investigate any client changes to its accounting policies relating to revenue.
- *Evaluate business purpose*. Discuss with management the business reasons for any unusual sale transactions.
- *Review accrued revenue*. Investigate the reasons for any journal entries that accrue revenue.
- *Review consignment transactions*. Look for consignment arrangements and investigate whether the client is accounting for them correctly.
- *Examine sales returns*. Evaluate whether sales returns are being recognized in the correct period.
- *Examine sales returns allowance*. Test the adequacy of the sales returns allowance.
- *Test for intercompany sales*. Investigate whether any recorded sales were to other subsidiaries of the client.
- *Verify cancellation of shipping documents*. Determine whether incorrect shipping documents were appropriately cancelled.
- *Verify segregation of duties*. Investigate whether there are sufficient levels of job segregation for the positions involved with revenue-generating activities.
- *Search for related parties*. Investigate whether sales were to related parties.
- *Confirm the absence of side agreements*. Review returned receivable confirmations to see if the client had any side agreements with its customers.
- *Conduct analytical procedures*. Use ratio and trend analysis to see if there are any disparities worth discussing with management.
- *Review presentation*. Review the client's presentation of information in its financial statements related to revenues, including disclosures in the accompanying footnotes.

Note: When there is considered to be a significant risk, it is not sufficient for the auditor to address the risk just by relying on analytical procedures, nor is it allowable to rely on evidence obtained in prior periods in regard to the effectiveness of controls.

Further clarification of the preceding procedures is provided in the following sections.

Examine Sales Cutoff

When a client ships goods to its customers, it probably records a sale transaction as soon as the goods are shipped. If so, it should use prenumbered shipping documents to identify the order in which goods are shipped, so that all shipments after a certain document number can be clearly identified as belonging to the following reporting period. The auditor's task is to determine the last shipping document associated with the reporting period, and then verify that no shipping documents with later sequential numbers were included in the sales for the reporting period.

EXAMPLE

The bill of lading number of the last shipment made in the preceding fiscal year was 3472. Therefore, all sales recorded by the client within the reporting period should have bill of lading numbers associated with them that are lower than or equal to 3472. All higher bill of lading numbers should be linked to sales that are recorded in subsequent periods.

If a client's shipping documents are not prenumbered, it can be quite difficult to ensure a clean cutoff. This issue can be minimized by examining client shipping procedures prior to the end of the reporting period, and recommending the immediate adoption of prenumbered shipping documents.

Verify that Invoices are Correct

Invoices are the foundation document from which sales are derived, so the auditor needs to verify that the information on a selection of invoices is correct. Doing so involves the following activities:

- Compare invoiced prices to the client's approved price list
- Recalculate price extensions (unit quantity × price per unit)
- Recalculate grand totals
- Compare part numbers and descriptions for items billed to the part numbers and descriptions for items shipped

Verify that Sales Transactions are Properly Recorded

Every sale transaction should be posted to the sales ledger, which is then posted to one of the sales accounts in the general ledger. The ending balances in the general ledger are then aggregated into the income statement. To ensure that this is the case, the auditor should trace a sample of customer billings to the sales journal, reviewing the dates and amounts of these invoices. Also, verify whether all sales transactions recorded in the sales journal are then posted to the general ledger. Further, verify that all sales accounts in the general ledger are properly rolling up into the sales line items in the income statement.

If sales were made for cash, the auditor can compare daily totals in the sales journal with cash register readings or tapes. If a more manual cash sales system is used by the client, with individual sales tickets being filled out for each sale, then the auditor can examine a selection of sales tickets for accuracy, and then trace them forward into the sales journal.

It is possible that goods will be shipped to customers or services provided, but no associated sale is recorded in the client's accounting system. To test for this, review the sequence of prenumbered shipping documents to see if they are all carried forward into customer billings. Similarly, review the record of employee chargeable time to see if these billable hours were charged to customers.

The reverse situation may also apply, where a client mistakenly issues a duplicate billing to a customer. The auditor can test for this situation by looking for duplicate amounts issued to the same customer. A duplicate billing may be triggered by a photocopy of a shipping document that was forwarded to the accounting department, so it can make sense to look for copies of supporting documents when examining supporting documentation.

Another problem may be that a transaction is recorded in the wrong account. This is a particular concern when non-sale transactions are recorded in a sales account, such as when the sale of a fixed asset is recorded as revenue, rather than as a reduction of the fixed asset account. This issue can be addressed as part of a more general examination of a sample of invoices.

Examine Supporting Documentation

Every sale transaction should be supported by a customer order and evidence of delivery. Accordingly, the auditor should examine the supporting documentation for a selection of sale transactions. This examination should include verification that a customer order exists, that the items ordered were the same ones shipped and billed, and that the prices charged match the client's standard price lists. If there is a concern that fictitious sales are being generated, examine the client's perpetual inventory records to see if inventory items were removed from stock in support of each sale made.

Note: The client may transfer the information on a customer purchase order to an internal sales order document. If so, it is possible that the sales order information does not match the customer purchase order, so be sure to trace the sale information all the way back to the originating purchase order, not just the sales order.

Someone intent on fraudulently boosting sales may not have the time to create a complete set of supporting documents. Consequently, missing documents should be considered a strong indicator of a fraudulent sale transaction. Another possibility is that a legitimate sale is artificially inflated by manually altering a customer's order. To detect these situations, look for altered sale documents, or documents that appear to be photocopies of the original.

Examine Multi-Component Sales

A client may enter into sales transactions that have multiple components. If so, examine how sales are allocated to each component of the total transaction, as well as how revenue is recognized for each of those components. In particular, verify whether a sufficient proportion of total revenue is being assigned to components for which revenue is recognized over a long period of time; clients tend to minimize the sales allocated to these components, so that they can accelerate the recognition of revenue.

Review Customer Contracts

The client may have entered into unusual contract terms just prior to its year end in order to inflate its sales. For example, it could offer an extended return policy or structure a deal to buy back goods in the following year, where the business purpose is clearly to inflate sales. The auditor can review the larger customer contracts still open at year-end to see if any of these terms exist. If so, the result may be a delay in revenue recognition for the related sales.

Review Changes in Accounting Policies

A client may alter its accounting policies related to the recognition of revenue. By doing so, management may be attempting to accelerate revenue recognition. When there is such a change in policy, the auditor should examine its effect on the amount of reported revenue over what would have been reported under the old policy. The auditor should also discuss the change with management, to gain an understanding of why the change was made. A final consideration is whether the change is allowable under the applicable accounting standards.

Evaluate Business Purpose

Most sales transactions recorded by a client will follow its normal sales patterns, through its ongoing sales channels and involving its normal product lines. However, there may be unusual sales transactions that fall outside of these sales patterns. For example, there may be an unusually large sale to an entirely new customer, or perhaps a sale of assets that are not considered part of the client's normal product list. There is a risk that these unusual transactions were formulated specifically to bolster the reported sales figure, perhaps doing so by sidestepping the revenue recognition guidelines established by the accounting standards. If so, the auditor should review these transactions in detail to ascertain their underlying business purpose.

Review Accrued Revenue

There may be circumstances under which a client will accrue revenue. This circumstance is most likely under a longer-term contract, where the client is recognizing revenue based on a percentage of completion arrangement. The auditor should examine these accruals to see if they are appropriate under the terms of the applicable accounting standards. If a percentage of completion is used as the basis for a revenue accrual, examine how the percentage of completion was compiled and whether this percentage is reasonable. A possible action item is to compare prior-year estimates of cost to the actual costs of completed projects, to see if the client has a history of being able to accurately estimate the percentage of completion.

Review Consignment Transactions

When a client issues inventory to a third party on consignment, there is no revenue recognition, since the client still owns the inventory. The auditor should watch for consignment arrangements, which may be noted through the presence of consignment contracts; the names of the consignees or information on their websites may also indicate the nature of the arrangement.

Clients that rarely engage in consignment arrangements are the most likely to incorrectly record these inventory transfers as sale transactions, since they are less likely to have accounting procedures for how to deal with consignments, or their accounting staffs ignore the procedures.

> **Tip:** When a consignee is discovered, add it to a list of discovered consignees for the client, and carry this document forward into the next annual audit, so that the next audit team can use it as the basis for a review of consignment transactions.

An indicator that a consignment arrangement exists is when there is one large initial entry to accounts receivable, followed by a series of smaller pay-down entries against the receivable. This indicates that the client is only receiving payment from the consignee when the consignee sells the transferred inventory to a third party. A return of goods months after a recorded sale can also indicate a consignment arrangement, since it indicates that the consignee is returning any goods that it was unable to sell.

Examine Sales Returns

The level of sales returns should be relatively consistent from period to period. When this is not the case, and especially when sales returns are unusually high in the period immediately following the period being audited, there is a reasonable suspicion that the client has delayed the recognition of sales returns in order to boost its reported sales in the period being audited. The auditor can test for this situation by reviewing the supporting documentation for a sample of sales returns recorded in the following month to determine the date of the original sale. The outcome may be an adjustment to record the delayed sales returns in the prior reporting period.

> **Tip:** Sales returns may be so minor that the auditor can safely consider them to be immaterial. If so, there is no need to conduct any audit procedures related to them.

Examine Sales Returns Allowance

If a client experiences a relatively large number of sales returns, it may establish a sales returns allowance. By doing so, it can recognize the amount of returns that will occur in subsequent periods, and offset these returns against the originating sales. The auditor can test the adequacy of the amount in this allowance in the following ways:

- Review the method used to determine the size of the allowance.
- Review the prior-year allowance to see if management has a bias in favor of over or under-estimating the size of the allowance.
- Review actual sales returns after the client's year-end to evaluate the accuracy of the allowance.

Test for Intercompany Sales

The client may be shipping goods between its own locations, perhaps among different subsidiaries. These transactions are intercompany sales and so should be stripped out of the client's consolidated financial statements. The auditor can test for these sales by searching for the names and addresses of other company locations in the bill-to addresses on client invoices.

Verify Cancellation of Shipping Documents

A client may sometimes fill out a shipping document, such as a bill of lading, and then cancel the related shipment. The auditor should test whether there is a process in place for cancelling these documents, so that they are not inadvertently forwarded to the accounting department, resulting in billings to customers.

Verify Segregation of Duties

There should be a strong segregation of duties between the shipping and billing functions. With this segregation in place, someone in the shipping department will be unable to ship goods after the reporting period has concluded, while still issuing a customer invoice that records the related sale as being within the reporting period. The auditor can test for segregation of duties by conducting a walkthrough of a sample transaction, as well as by observing how shipping and billing transactions are handled by the client's staff. A walkthrough of a sale transaction is also useful for understanding a client's control systems and any potential control weaknesses, as well as for noting any changes in policies and procedures during the past year.

Search for Related Parties

It is possible that some of the sales reported by a client are with related parties, such as its officers, directors, or shareholders. It can be difficult to ascertain which sales are with related parties, so the auditor may have to follow multiple procedures in order to identify them. Consider the following actions:

- Review customer agreements for unusual terms.
- Review unusual transactions occurring near the end of the client's fiscal year.
- Review board minutes for documentation of related party dealings.
- Examine any conflict of interest disclosures that employees have made to the client.
- Review the client's proxy filings with the Securities and Exchange Commission to see if any related party transactions were reported (only available for public companies).

Whenever a related party transaction is uncovered, the auditor should do the following:

- Determine whether the transactions have been approved.
- Confirm the terms of the arrangements with the related parties.
- Evaluate the collectability of related receivables.
- Determine whether the client's related party disclosures are adequate.

Confirm the Absence of Side Agreements

As part of the auditor's standard issuance of confirmations to the customers of a client, ask the customers to confirm whether there are any side agreements with the client as part of its sales to them. This question may uncover situations where the client has offered extended rights of return to its customers, which may impact the timing of revenue recognition.

Conduct Analytical Procedures

Analytical procedures involve comparisons of different sets of financial and operational information, to see if historical relationships are continuing forward into the period under review. In most cases, these relationships should remain consistent over time. If not, it can imply that the financial records are incorrect, possibly due to errors or fraudulent reporting activity. The following analytical procedures can be applied to revenue:

- Calculate the days sales outstanding (calculated as accounts receivable divided by annual sales, which is then multiplied by the number of days in the year). When plotted on a trend line, DSO should be relatively consistent from year to year. Since falsified sales cannot be collected, this

means that DSO will increase as false sales are added, thereby increasing the balance in the accounts receivable account.

- Calculate the gross margin percentage (calculated as net sales minus the cost of goods sold, divided by net sales). When plotted on a trend line, this percentage should be relatively consistent over time. An increase in the percentage indicates that there may be fake sales against which there were no accrued costs for goods or services sold.

Tip: A canny client could create accrued expenses in the cost of goods sold account to artificially preserve the long-term gross margin percentage. To detect this, look for a spike in accrued expenses that coincides with a slow-down in receivables turnover.

It is quite possible that both effects will be present, where receivables turnover slows down and the gross margin percentage increases.

Additional analytical procedures are as follows:

- Construct a trend line of revenue by product line or business segment, to see if there are unusual changes.
- Compare the reported revenue level to the productive capacity of the client. If the reported revenue level is approaching or exceeding the theoretical capacity of the business, there is a strong possibility that reported sales levels are being inflated. An alternative explanation is that the client has outsourced a portion of its production to third parties.
- Calculate the ratio of sales returns and allowances to sales, preferably on a trend line. A decline in the ratio can indicate that the client is delaying the recordation of sales returns and allowances, which may trigger an investigation of these transactions in the period after the period being audited. An increase in the ratio can indicate that the client is offering generous terms for returns and allowances in order to force more sales onto its customers.
- Scan the revenue accounts in the general ledger for unusual journal entries or other postings, or transactions that appear to be unusually large. Then discuss the nature of these items with management. This analysis can sometimes uncover incorrect or fraudulent postings.

When the results of these procedures are materially different from expectations, the auditor should discuss them with the client's management. A certain amount of skepticism is needed when having this discussion, since management may not want to spend the time to delve into a detailed explanation, or may be hiding fraudulent behavior. Management responses should be documented, and could be valuable as a baseline when conducting the same analysis in the following year.

Review Presentation

The client's financial statements should disclose information about its revenues, which will vary depending on the types of transactions in which the client engages. The following three areas will likely need to be addressed:

- *Contracts*. Disclose the amount of revenue recognized, any revenue impairments, the disaggregation of revenue, performance obligations, contract balances, and the amount of the transaction price allocated to the remaining performance obligations. Contract balances should include beginning and ending balances of receivables, contract assets, and contract liabilities.
- *Judgments*. Note the timing associated with when performance obligations are satisfied, as well as how the transaction price was determined and how it was allocated to the various performance obligations.

- *Asset recognition*. Note the recognized assets associated with obtaining or completing the terms of all contracts. This shall include the closing balances of contract-related assets by main category of asset, such as for setup costs and the costs to obtain contracts.

The auditor should investigate these disclosures and determine whether they adequately present the situation.

Internal Controls Used by the Client

As noted earlier in the Auditor Objectives section, the auditor needs to gain an understanding of the client's controls over its revenues. Since revenues are the largest line item on the income statement, most clients should have a strong system of internal controls in place. Otherwise, there is a risk of material misstatement or fraud. Consequently, the auditor should look for a mix of the following internal controls when evaluating the client's controls over revenue. The auditor can design various tests to verify the effectiveness of these controls. For example, one could select a sample of customer billings and review the associated documentation to see if the billings were properly compiled, checked, and recorded in the accounting records. Auditor tests of controls are especially necessary when sufficient audit evidence cannot be obtained just from substantive procedures.

We note a broad range of possible controls in the following bullet points. A client may not use all of them, since doing so may not be efficient or could interfere with process flows.

Control Environment

- *Integrity and ethical values*. There is a risk of misstating revenues in order to boost the reported profit level. Management must set the highest possible ethical standards for all employees, so that there is no temptation to inflate revenue. Management should also avoid using any incentives that would tend to encourage improper reporting, such as bonuses that are tied to profit levels.
- *Commitment to competence*. The client should be committed to hiring and providing adequate training for its accounting personnel, since they must understand when it is appropriate to bill customers.

Verifications

- *Confirm discounts and special prices*. If there are discounts or special prices noted on the sales order that are different from the standard price list, it may make sense to confirm them with the sales manager or controller.
- *Verify remaining funding level*. If a billing is for a contract that has a fixed amount of total funding, verify the remaining amount of funding available under the contract, and ensure that the invoice total does not exceed the amount of available funding. Otherwise, the invoice will almost certainly be rejected by the customer.
- *Use automatic data validation*. If customer billings are being created in a computerized billing module of the accounting software, include as much automatic data validation in the on-line form as possible. This can include comparison of prices to a standard price list, address checking, and automated sales tax and freight charge generation.
- *Check invoices for errors*. Have a second person examine invoices for errors before they are issued. This is important when invoices are quite large, since an error could potentially hold up a large payment.
- *Review unmatched bills of lading*. At the end of the daily invoice processing, the billing clerk should have no bills of lading for which there is not an associated invoice. If there is an unmatched bill of lading, the clerk should create an invoice for it at once.
- *Compare sales order total to invoice total*. If the total amount of the prospective billing on the sales order does not match the total on the invoice, this tells the billing clerk that there are probably more

items to be delivered at a later date, which should trigger the filing of a copy of the sales order in the pending folder, in anticipation of more shipments.
- *Issue statements*. A possible control is to issue a statement to all customers, noting the payment status of all outstanding invoices. If customers call back to ask for invoice copies, it is possible that the company did not mail the invoices, or sent them to the wrong address. Consequently, always follow up on customer inquiries stemming from statements of account.
- *Match sales orders to invoices*. Periodically run a report that lists all filled sales orders, and compare it to invoices issued to customers. There should be an investigation of any filled sales orders for which no corresponding invoice can be found.
- *Use revenue recognition procedure*. When a firm sells more complex arrangements, such as a package of products and support services, it should have a procedure in place for its accounting staff that details exactly how revenue is to be measured and the milestones at which it is recognized.

Authorizations

- *Segregation of duties*. The shipping clerk should not be able to issue invoices to customers. Otherwise, a shipping clerk could create fake shipping documentation to support the recordation of a fake invoice that generates a fraudulent sale.
- *Credit approvals*. All sales made on credit should first be run through the credit department, to see if customers qualify for a sufficient amount of credit. Alternatively, the accounting system can automatically match a customer order to the remaining approved amount of credit available to that customer. In either case, the intent is to ensure that the client does not issue an excessive amount of credit to its customers, which would raise the prospect of substantial bad debt losses.

Cutoff

- *Prenumbered shipping documents*. Bills of lading are prenumbered. Doing so makes it easier to spot any later-numbered bills of lading that have been incorrectly recorded in a prior period.
- *Instruct the billing clerk regarding cutoff timing*. The controller can notify the billing clerk of the need for a proper month-end cutoff at the end of each accounting period.

It is not sufficient to simply inquire about the existence of the preceding controls. Direct observation of revenue-related transactions is needed to ensure that the controls have been implemented and are operating at all times. If this examination reveals that existing controls are not as effective as anticipated, then it will be necessary to adjust audit procedures, based on a revised risk of material misstatement.

Advance Work

If the revenue recognition practices within an industry are unusually specialized, it can make sense for the auditor to assign personnel to the audit who have significant experience in the client's industry.

Summary

The managers of some organizations can find themselves under intense pressure to achieve robust financial results. When their actual performance results are not adequate, they sometimes engage in the fraudulent expansion of reported sales. In addition, some entities have weak controls over the revenue recordation process or do not have a clear understanding of when revenue can be recognized. These issues make revenue one of the key areas of concern for the auditor, who faces a significant risk of material misstatement. The auditor must develop an audit plan that accounts for this enhanced risk, which will likely require an extensive examination of client controls, as well as substantive procedures.

Review Questions

1. The following is a valid characteristic of revenue:
   a. Billings for shipped goods may be missed
   b. There are few period-end cutoff concerns
   c. Complex transactions can be accounted for with little need for a supporting procedure
   d. The fraud risk associated with revenue is unusually low

2. The risk of material misstatement can increase when:
   a. The client engages in bill and hold transactions
   b. The client periodically updates its product line
   c. The client requires its sales staff to follow standard contractual selling terms
   d. The client engages in cash sales and purchases

3. The following activity is associated with the control environment of a business:
   a. Confirm special prices granted to customers
   b. Prenumber bills of lading
   c. Segregation of duties for shipping and billing
   d. Commit to providing adequate training for accounting personnel

Chapter 2
Revenue Rules

Learning Objectives

- Identify the circumstances under which a contract does and does not exist.
- Recognize the steps used in the revenue recognition process.
- Describe how and when the expected value method is used.
- Recognize the accounting rules that apply to noncash assets, nonrefundable fees, and customer acceptance.

Introduction

The preceding chapter dealt with the specifics of how to audit revenue. In addition, the auditor will need a working knowledge of the revenue rules, which can then be applied to the results found in an audit. This chapter outlines the essential revenue rules. For more detail about revenue rules, as well as examples, please consult the author's *Revenue Recognition* course, from which this chapter was extracted.

Topic 606, Revenue from Contracts with Customers

The most comprehensive accounting standard that deals with revenue recognition is Topic 606 of the Accounting Standards Codification, *Revenue from Contracts with Customers*. This standard establishes a consistent framework for how to address revenue issues, while at the same time eliminating a number of inconsistencies in prior accounting standards relating to revenue. The result is a high level of comparability of revenue practices across multiple industries.

Topic 606 is now the overarching revenue standard, since it applies to any entity that contractually sells goods or services to customers. This accounting standard focuses on the overall principles guiding the recognition of revenue, rather than establishing a large number of detailed rules to govern the actions of accountants. The result is a topic that emphasizes the use of judgment in following general guidelines.

Topic 606 does not completely supplant the revenue-related guidance in other accounting standards. In cases where more detailed guidance is available in the accounting standards that deal with a transaction, the more detailed guidance should be applied rather than the guidance found in Topic 606.

The following sections delve into the essentials of *Revenue from Contracts with Customers*.

Steps in Revenue Recognition

Topic 606 establishes a series of actions that an entity takes to determine the amount and timing of revenue to be recognized. The main steps are:

1. Link the contract with a specific customer.
2. Note the performance obligations required by the contract.
3. Determine the price of the underlying transaction.
4. Match this price to the performance obligations through an allocation process.
5. Recognize revenue as the various obligations are fulfilled.

We will expand upon each of these steps in the following sections.

Step One: Link Contract to Customer

The contract is used as a central aspect of revenue recognition, because revenue recognition is closely associated with it. In many instances, revenue is recognized at multiple points in time over the duration of a contract, so linking contracts with revenue recognition provides a reasonable framework for establishing the timing and amounts of revenue recognition.

A contract only exists if there is an agreement between the parties that establishes enforceable rights and obligations. It is not necessary for an agreement to be in writing for it to be considered a contract. More specifically, a contract only exists if the following conditions are present:

- *Approval*. All parties to the contract have approved the document and substantially committed to its contents (based on all relevant facts and circumstances). The parties can be considered to be committed to a contract despite occasional lapses, such as not enforcing prompt payment or sometimes shipping late. Approval can be in writing or orally.
- *Rights*. The document clearly identifies the rights of the parties.
- *Payment*. The payment terms are clearly stated. It is acceptable to recognize revenue related to unpriced change orders if the seller expects that the price will be approved and the scope of work has been approved.
- *Substance*. The agreement has commercial substance; that is, the cash flows of the seller will change as a result of the contract, either in terms of their amount, timing, or risk of receipt. Otherwise, organizations could swap goods or services to artificially boost their revenue.
- *Probability*. It is probable that the organization will collect substantially all of the amount stated in the contract in exchange for the goods or services that it commits to provide to the other party. In this context, "probable" means "likely to occur." This evaluation is based on the customer's ability and intention to pay when due. The evaluation can incorporate a consideration of the past practice of the customer in question, or of the class of customers to which that customer belongs.

There may be instances in which the preceding criteria are not met, and yet the customer is paying consideration to the seller. If so, revenue can be recognized only when one or more of the following events has occurred:

- The contract has been terminated and the consideration received by the seller is not refundable; or
- The seller has no remaining obligations to the customer, substantially all of the consideration has been received, and the payment is not refundable; or
- The seller has transferred control of the goods or services, *and* has stopped transferring goods or services to the customer, *and* has no obligation to transfer additional goods or services, *and* the consideration received cannot be refunded.

These alternatives focus on whether the contract has been concluded in all respects. If so, there is little risk that any revenue recognized will be reversed in a later period, and so is a highly conservative approach to recognizing revenue.

If the seller receives consideration from a customer and the preceding conditions do not exist, then the payment is to be recorded as a liability until such time as the sale criteria have been met.

A contract is not considered to exist when each party to the contract has a unilateral right to terminate a contract that has not been performed, and without compensating the other party. An unperformed contract is one in which no goods or services have been transferred to the customer, nor has the seller received any consideration from the customer in exchange for any promised goods or services.

Step Two: Note Performance Obligations

A performance obligation is essentially the unit of account for the goods or services contractually promised to a customer. The performance obligations in the contract must be clearly identified. This is important in

recognizing revenue, since revenue is considered to be recognizable when goods or services are transferred to the customer. Examples of goods and services are noted in the following table.

Examples of Goods and Services

Item Sold	Example of the Seller
Arranging for another party to transfer goods or services	Travel agent selling airline tickets
Asset construction on behalf of a customer	Building construction company
Grant of a license	Software company issuing licenses to use its software
Grant of options to purchase additional goods or services	Airline granting frequent flier points
Manufactured goods	Manufacturer
Performance of contractually-mandated tasks	Consultant
Readiness to provide goods or services as needed	Snow plow operator, alarm system monitoring
Resale of merchandise	Retailer
Resale of rights to goods or services	Selling a priority for a new-model car delivery
Rights to future goods or services that can be resold	Wholesaler gives additional services to retailer buying a particular product

There may also be an implicit promise to deliver goods or services that is not stated in a contract, as implied by the customary business practices of the seller. If there is a valid expectation by the customer to receive these implicitly-promised goods or services, they should be considered a performance obligation. Otherwise, the seller might recognize the entire transaction price as revenue when in fact there are still goods or services yet to be provided.

If there is no performance obligation, then there is no revenue to be recognized. For example, a company could continually build up its inventory through ongoing production activities, but just because it has more sellable assets does not mean that it can report an incremental increase in the revenue in its income statement. If such an activity-based revenue recognition model were allowed, organizations could increase their revenues simply by increasing their rate of activity.

If there is more than one good or service to be transferred under the contract terms, only break it out as a separate performance obligation if it is a distinct obligation or there are a series of transfers to the customer of a distinct good or service. In the latter case, a separate performance obligation is assumed if there is a consistent pattern of transfer to the customer.

The "distinct" label can be applied to a good or service only if it meets both of the following criteria:

- *Capable of being distinct*. The customer can benefit from the good or service as delivered, or in combination with other resources that the customer can readily find; and
- *Distinct within the context of the contract*. The promised delivery of the good or service is separately identified within the contract.

Goods or services are more likely to be considered distinct when:

- The seller does not use the goods or services as a component of an integrated bundle of goods or services.
- The items do not significantly modify any other goods or services listed in the contract.
- The items are not highly interrelated with other goods or services listed in the contract.

The intent of these evaluative factors is to place a focus on how to determine whether goods or services are truly distinct within a contract. There is no need to assess the customer's intended use of any goods or services when making this determination.

In the event that a good or service is not classified as distinct, aggregate it with other goods or services promised in the contract, until such time as a cluster of goods or services have been accumulated that can be considered distinct.

Step Three: Determine Prices

This step involves the determination of the transaction price built into the contract. The transaction price is the amount of consideration to be paid by the customer in exchange for its receipt of goods or services. The transaction price does not include any amounts collected on behalf of third parties (such as sales taxes). The transaction price may be difficult to determine, since it involves consideration of the effects noted in the following subsections.

Variable Consideration

The terms of some contracts may result in a price that can vary, depending on the circumstances. For example, there may be discounts, rebates, penalties, or performance bonuses in the contract. Or, the customer may have a reasonable expectation that the seller will offer a price concession, based on the seller's customary business practices, policies, or statements. Another example is when the seller intends to accept lower prices from a new customer in order to develop a strong customer relationship. If so, set the transaction price based on either the most likely amount or the probability-weighted expected value, using whichever method yields that amount of consideration most likely to be paid. In more detail, these methods are:

- *Most likely.* The seller develops a range of possible payment amounts, and selects the amount most likely to be paid. This approach works best when there are only two possible amounts that will be paid.
- *Expected value.* The seller develops a range of possible payment amounts, and assigns a probability to each one. The sum of these probability-weighted amounts is the expected value of the variable consideration. This approach works best when there are a large number of possible payment amounts. However, the outcome may be an expected value that does not exactly align with any amount that could actually be paid.

Whichever method is chosen, be sure to use it consistently throughout the contract, as well as for similar contracts. However, it is not necessary to use the same measurement method to measure each uncertainty contained within a contract; different methods can be applied to different uncertainties.

Also, review the circumstances of each contract at the end of each reporting period, and update the estimated transaction price to reflect any changes in the circumstances.

Possibility of Reversal

Do not include in the transaction price an estimate of variable consideration if, when the uncertainty associated with the variable amount is settled, it is probable that there will be a significant reversal of cumulative revenue recognized. The assessment of a possible reversal of revenue could include the following factors, all of which might increase the probability of a revenue reversal:

- *Beyond seller's influence*. The amount of consideration paid is strongly influenced by factors outside of the control of the seller. For example, goods sold may be subject to obsolescence (as is common in the technology industry), or weather conditions could impede the availability of goods (as is common in the production of farm products).
- *Historical practice*. The seller has a history of accepting a broad range of price concessions, or of changing the terms of similar contracts.

- *Inherent range of outcomes*. The terms of the contract contain a broad range of possible consideration amounts that might be paid.
- *Limited experience*. The seller does not have much experience with the type of contract in question. Alternatively, the seller's prior experience cannot be translated into a prediction of the amount of consideration paid.
- *Long duration*. A considerable period of time may have to pass before the uncertainty can be resolved.

Time Value of Money

If the transaction price is to be paid over a period of time, this implies that the seller is including a financing component in the contract. If this financing component is a significant financing benefit for the customer and provides financing for more than one year, adjust the transaction price for the time value of money. In cases where there is a financing component to a contract, the seller will earn interest income over the term of the contract.

A contract may contain a financing component, even if there is no explicit reference to it in the contract. When adjusting the transaction price for the time value of money, consider the following factors:

- *Standalone price*. The amount of revenue recognized should reflect the price that a customer would have paid if it had paid in cash.
- *Significance*. In order to be recognized, the financing component should be significant. This means evaluating the amount of the difference between the consideration to be paid and the cash selling price. Also note the combined effect of prevailing interest rates and the time difference between when delivery is made and when the customer pays.

If it is necessary to adjust the compensation paid for the time value of money, use as a discount rate the rate that would be employed in a separate financing transaction between the parties as of the beginning date of the contract. The rate used should reflect the credit characteristics of the customer, including the presence of any collateral provided. This discount rate is not to be updated after the commencement of the contract, irrespective of any changes in the credit markets or in the credit standing of the customer.

Also, note that the financing concept can be employed in reverse; that is, if a customer makes a deposit that the seller expects to retain for more than one year, the financing component of this arrangement should be recognized by the seller. Doing so properly reflects the economics of the arrangement, where the seller is using the cash of the customer to fund its purchase of materials and equipment for a project; if the seller had not provided the deposit, the seller would instead have needed to obtain financing.

There is assumed *not* to be a significant financing component to a contract in the presence of any of the following factors:

- *Advance payment*. The customer paid in advance, and the customer can specify when goods and services are to be delivered.
- *Variable component*. A large part of the consideration to be paid is variable, and payment timing will vary based on a future event that is not under the control of either party.
- *Non-financing reason*. The reason for the difference between the contractual consideration and the cash selling price exists for a reason other than financing, and the amount of the difference is proportional to the alternative reason.

Noncash Consideration

If the customer will be paying with some form of noncash consideration, measure the consideration at its fair value as of the inception date of the contract. If it is not possible to measure the payment at its fair value, instead use the standalone selling price of the goods or services to be delivered to the customer. This approach also applies to payments made with equity instruments. In rare cases, the customer may supply

the seller with goods or services that are intended to assist the seller in its fulfillment of the related contract. If the seller gains control of these assets or services, it should consider them to be noncash consideration paid by the customer.

Step Four: Allocate Prices to Obligations

Once the performance obligations and transaction prices associated with a contract have been identified, the next step is to allocate the transaction prices to the obligations. The basic rule is to allocate that price to a performance obligation that best reflects that amount of consideration to which the seller expects to be entitled when it satisfies each performance obligation. To determine this allocation, it is first necessary to estimate the standalone selling price of those distinct goods or services as of the inception date of the contract. If it is not possible to derive a standalone selling price, the seller must estimate it. This estimation should involve all relevant information that is reasonably available, such as:

- Competitive pressure on prices
- Costs incurred to manufacture or provide the item
- Item profit margins
- Pricing of other items in the same contract
- Standalone selling price of the item
- Supply and demand for the items in the market
- The seller's pricing strategy and practices
- The type of customer, distribution channel, or geographic region
- Third-party pricing

The following three approaches are acceptable ways in which to estimate a standalone selling price:

- *Adjusted market assessment*. This involves reviewing the market to estimate the price at which a customer in that market would be willing to pay for the goods and services in question. This can involve an examination of the prices of competitors for similar items and adjusting them to incorporate the seller's costs and margins.
- *Expected cost plus a margin*. This requires the seller to estimate the costs required to fulfill a performance obligation, and then add a margin to it to derive the estimated price.
- *Residual approach*. This involves subtracting all of the observable standalone selling prices from the total transaction price to arrive at the residual price remaining for allocation to any non-observable selling prices. This method can only be used if one of the following situations applies:
    - The seller sells the good or service to other customers for a wide range of prices; or
    - No price has yet been established for that item, and it has not yet been sold on a standalone basis.

The residual approach can be difficult to use when there are several goods or services with uncertain standalone selling prices. If so, it may be necessary to use a combination of methods to derive standalone selling prices, which should be used in the following order:

1. Estimate the aggregate amount of the standalone selling prices for all items having uncertain standalone selling prices, using the residual method.
2. Use another method to develop standalone selling prices for each item in this group, to allocate the aggregate amount of the standalone selling prices.

Once all standalone selling prices have been determined, allocate the transaction price amongst these distinct goods or services based on their relative standalone selling prices.

Once the seller derives an approach for estimating a standalone selling price, it should consistently apply that method to the derivation of the standalone selling prices for other goods or services with similar characteristics.

If there is a subsequent change in the transaction price, allocate that change amongst the distinct goods or services based on the original allocation that was used at the inception of the contract. If this subsequent allocation is to a performance obligation that has already been completed and for which revenue has already been recognized, the result can be an increase or reduction in the amount of revenue recognized. This change in recognition should occur as soon as the subsequent change in the transaction price occurs.

Allocation of Price Discounts

It is assumed that a customer has received a discount on a bundled purchase of goods or services when the sum of the standalone prices for these items is greater than the consideration to be paid under the terms of a contract. The discount can be allocated to a specific item within the bundled purchase, if there is observable evidence that the discount was intended for that item. In order to do so, all of the following criteria must apply:

1. Each distinct item in the bundle is regularly sold on a standalone basis;
2. A bundle of some of these distinct items is regularly sold at a discount to their standalone selling prices; and
3. The discount noted in the second point is essentially the same as the discount in the contract, and there is observable evidence linking the entire contract discount to that bundle of distinct items.

If this allocation system is used, the seller must employ it before using the residual approach noted earlier in this section. Doing so ensures that the discount is not applied to the other performance obligations in the contract to which prices have not yet been allocated.

In all other cases, the discount is to be allocated amongst all of the items in the bundle. In this latter situation, the allocation is to be made based on the standalone selling prices of all of the performance obligations in the contract.

Allocation of Variable Consideration

There may be a variable amount of consideration associated with a contract. This consideration may apply to the contract as a whole, or to just a portion of it. For example, a bonus payment may be tied to the completion of a specific performance obligation. It is allowable to allocate variable consideration to a specific performance obligation or a distinct good or service within a contract when the variable payment terms are specifically tied to the seller's efforts to satisfy the performance obligation.

Subsequent Price Changes

There are a number of reasons why the transaction price could change after a contract has begun, such as the resolution of uncertain events that were in need of clarification at the contract inception date. When there is a price change, the amount of the change is to be allocated to the performance obligations on the same basis used for the original price allocation at the inception of the contract. This has the following ramifications:

- Do not re-allocate prices based on subsequent changes in the standalone selling prices of goods or services.
- When there is a price change and that price is allocated, the result may be the recognition of additional or reduced revenue that is to be recognized in the period when the transaction price changes.
- When there has been a contract modification prior to a price change, the price allocation is conducted in two steps. First, allocate the price change to those performance obligations identified prior to the modification if the price change is associated with variable consideration promised

before modification. In all other cases, allocate the price change to those performance obligations still remaining to be settled as of the modification date.

The result should be a reported level of cumulative revenue that matches the amount of revenue an organization would have recognized if it had the most recent information at the inception date of the contract.

Step Five: Recognize Revenue

Revenue is to be recognized as goods or services are transferred to the customer. This transference is considered to occur when the customer gains control over the good or service. Indicators of this date include the following:

- When the seller has the right to receive payment.
- When the customer has legal title to the transferred asset. This can still be the case even when the seller retains title to protect it against the customer's failure to pay.
- When physical possession of the asset has been transferred by the seller. Possession can be inferred even when goods are held elsewhere on consignment, or by the seller under a bill and hold arrangement. Under a bill and hold arrangement, the seller retains goods on behalf of the customer, but still recognizes revenue. This topic is addressed in the Bill and hold Arrangements section in the next chapter.
- When the customer has taken on the significant risks and rewards of ownership related to the asset transferred by the seller. For example, the customer can now sell, pledge, or exchange the asset.
- When the customer accepts the asset.
- When the customer can prevent other entities from using or obtaining benefits from the asset.

It is possible that a performance obligation will be transferred over time, rather than as of a specific point in time. If so, revenue recognition occurs when any one of the following criteria are met:

- *Immediate use*. The customer both receives and consumes the benefit provided by the seller as performance occurs. This situation arises if another entity would not need to re-perform work completed to date if the other entity were to take over the remaining performance obligation. Routine and recurring services typically fall into this classification.
- *Immediate enhancement*. The seller creates or enhances an asset controlled by the customer as performance occurs. This asset can be tangible or intangible.
- *No alternative use*. The seller's performance does not create an asset for which there is an alternative use to the seller (such as selling it to a different customer). In addition, the contract gives the seller an enforceable right to payment for the performance that has been completed to date. A lack of alternative use happens when a contract restricts the seller from directing the asset to another use, or when there are practical limitations on doing so, such as the incurrence of significant economic losses to direct the asset elsewhere.

Construction contracts are likely to be designated as being performance obligations that are transferred over time. Under this approach, they can use the percentage-of-completion method to recognize revenue, rather than the completed contract method. This means that they can recognize revenue as a construction project progresses, rather than waiting until the end of the project to recognize any revenue.

Measurement of Progress Completion

When a performance obligation is being completed over a period of time, the seller recognizes revenue through the application of a progress completion method. The goal of this method is to determine the progress of the seller in achieving complete satisfaction of its performance obligation. This method is to be consistently applied over time, and shall be re-measured at the end of each reporting period.

Both output methods and input methods are considered acceptable for determining progress completion. The method chosen should incorporate due consideration of the nature of the goods or services being provided to the customer. The following sub-sections address the use of output and input methods.

Output Methods

An output method recognizes revenue based on a comparison of the value to the customer of goods and services transferred to date to the remaining goods and services not yet transferred. There are numerous ways to measure output, including:

- Surveys of performance to date
- Milestones reached
- The passage of time
- The number of units delivered
- The number of units produced

Another output method that may be acceptable is the amount of consideration that the seller has the right to invoice, such as billable hours. This approach works when the seller has a right to invoice an amount that matches the amount of performance completed to date.

The number of units delivered or produced may not be an appropriate output method in situations where there is a large amount of work-in-process, since the value associated with unfinished goods may be so substantial that revenue could be materially under-reported.

The method picked should closely adhere to the concept of matching the seller's progress toward satisfying the performance obligation. It is not always possible to use an output method, since the cost of collecting the necessary information can be prohibitive, or progress may not be directly observable.

Input Methods

An input method derives the amount of revenue to be recognized based on the to-date effort required by the seller to satisfy a performance obligation relative to the total estimated amount of effort required. Examples of possible inputs are costs incurred, labor hours expended, and machine hours used. If there are situations where the effort expended does not directly relate to the transfer of goods or services to a customer, do not use that input. The following are situations where the input used could lead to incorrect revenue recognition:

- The costs incurred are higher than expected, due to seller inefficiencies. For example, the seller may have wasted a higher-than-expected amount of raw materials in the performance of its obligations under a contract.
- The costs incurred are not in proportion to the progress of the seller toward satisfying the performance obligation. For example, the seller might purchase a large amount of materials at the inception of a contract, which comprise a significant part of the total price.

The situation described in the preceding example is quite common, since materials are typically procured at the inception of a contract, rather than being purchased in equal quantities over the duration of the contract. Consequently, the accountant should be particularly mindful of this issue and incorporate it into any revenue recognition calculations based on an input method.

A method based on output is preferred, since it most faithfully depicts the performance of the seller under the terms of a contract. However, an input-based method is certainly allowable if using it would be less costly for the seller, while still providing a reasonable proxy for the ongoing measurement of progress.

Progress Measurement

It is only possible to recognize the revenue associated with progress completion if it is possible for the seller to measure the seller's progress. If the seller lacks reliable progress information, it will not be possible to

recognize the revenue associated with a contract over time. There may be cases where the measurement of progress completion is more difficult during the early stages of a contract. If so, it is allowable for the seller to instead recognize just enough revenue to recover its costs in satisfying its performance obligations, thereby deferring the recognition of other revenue until such time as the measurement system yields more accurate results.

Right of Return

A common right granted to customers is to allow them to return goods to the seller within a certain period of time following the customer's receipt of the goods. This return may take the form of a refund of any amounts paid, a general credit that can be applied against other billings from the seller, or an exchange for a different unit. The proper accounting for this right of return involves three components, which are:

1. Recognize the net amount of revenue to which the seller expects to be entitled after all product returns have been factored into the sale.
2. A refund liability that encompasses the number of units that the seller expects to have returned to it.
3. An asset based on the right to recover products from customers who have demanded refunds. This asset represents a reduction in the cost of goods sold. The amount is initially based on the former carrying amount of the inventory, less recovery costs and expected reductions in the value of the returned products.

This accounting requires the seller to update its assessment of future product returns at the end of each reporting period, both for the refund liability and the recovery asset. This update may result in a change in the amount of revenue recognized.

Bill and Hold Arrangements

There is a bill and hold arrangement between a seller and customer when the seller bills the customer, but initially retains physical possession of the goods that were sold; the goods are transferred to the customer at a later date. This situation may arise if a customer does not initially have the storage space available for the goods it has ordered.

In a bill and hold arrangement, the seller must determine when the customer gains control of the goods, since this point in time indicates when the seller can recognize revenue. Customer control can be difficult to discern when the goods are still located on the premises of the seller. The following are indicators of customer control:

- The customer can direct the use of the goods, no matter where they are located
- The customer can obtain substantially all of the remaining benefits of the goods

Further, the following conditions must all be present for the seller to recognize revenue under a bill and hold arrangement:

- *Adequate reason*. There must be a substantive reason why the seller is continuing to store the goods, such as at the direct request of the customer.
- *Alternate use*. The seller must not be able to redirect the goods, either to other customers or for internal use.
- *Complete*. The product must be complete in all respects and ready for transfer to the customer.
- *Identification*. The goods must have been identified specifically as belonging to the customer.

Under a bill and hold arrangement, the seller may have a performance obligation to act as the custodian for the goods being held at its facility. If so, the seller may need to allocate a portion of the transaction price to the custodial function, and recognize this revenue over the course of the custodial period.

Consignment Arrangements

There may be a situation in which a seller delivers goods to another party, which are to then be sold to end customers. The intermediate party in this arrangement is typically a distributor or retailer. If the intermediate party has gained control of the goods upon receipt, the seller can recognize revenue related to the delivery. However, if the intermediate party has not gained control, this is considered to be a consignment arrangement. Under a consignment arrangement, the seller cannot recognize any revenue until the goods are eventually sold to end customers. Possible indicators that a consignment arrangement is present include the following:

- The goods are controlled by the seller until a later event, such as their sale to an end customer or the arrival of a specific date.
- The seller can require the intermediate party to either return the goods or transfer them to a third party (such as a different distributor or retailer).
- The intermediate party does not have an unconditional obligation to pay for the goods. This condition may still be the case, even if the party is required to pay a deposit to the seller.

Customer Acceptance

A customer may include an acceptance clause in a contract with a seller. An acceptance clause states that the customer has the right to inspect goods and reject them or demand proper remedial efforts before formal acceptance. Normally, customer control over goods occurs as soon as this acceptance step has been completed.

There are situations in which the seller can determine that control has passed to a customer, even if a formal acceptance review has not yet taken place. This typically occurs when customer acceptance is based upon a delivery meeting very specific qualifications, such as certain dimension or weight requirements. If the seller can determine in advance that these criteria have been met, it can recognize revenue prior to formal customer acceptance. If the seller cannot determine in advance that a customer will accept the delivered goods, it must wait for formal acceptance before it can confirm that the customer had taken control of the delivery, which then triggers revenue recognition.

Even if a customer recognizes revenue in advance of formal customer acceptance, it may still be necessary to determine whether there are any remaining performance obligations to which a portion of the transaction price should be allocated. For example, a seller may have an obligation to not only manufacture production equipment, but also to install it at the customer site. This later step could be considered a separate performance obligation.

A variation on the customer acceptance concept is when a seller delivers goods to a customer for evaluation purposes. In this case, the customer has no obligation to accept or pay for the goods until the end of a trial period, so control cannot be said to have passed to the customer until such time as the customer accepts the goods or the trial period ends.

Nonrefundable Upfront Fees

In some types of contracts, it is customary for the seller to charge a customer a nonrefundable upfront fee. Examples of these fees are:

- Health club member ship fee
- Phone service activation fee
- Long-term contract setup fee

There may be a performance obligation associated with these fees. In some cases, it could actually relate to an activity that the seller completes at the beginning of a contract. However, this activity rarely relates to the fulfillment of a performance obligation by the seller, and simply represents an expenditure.

Consequently, the most appropriate treatment of this fee is to recognize it as revenue when the goods or services stated in the contract are provided to the customer. Several additional issues to consider are:

- *Recognition period*. If the seller grants the customer a material option to renew the contract, the revenue recognition period associated with the upfront fee is extended over the additional contract term.
- *Setup costs*. It is possible that the costs incurred to set up a contract are an asset, which should be charged to expense over the course of the contract.

Principal versus Agent

There are situations where the party providing goods or services to a customer is actually arranging to have another party provide the goods and services. In this case, the party is an agent, not the principal party acting as seller. Use the rules in the following exhibit to differentiate between the two concepts of principal and agent.

Principal vs. Agent Criteria

Criterion	Principal	Agent
Controls the good or service before transfer to customer	Yes	No
Obtains legal title just prior to transfer to seller	Either	Either
Hires a subcontractor to fulfill some performance obligations	Yes	No
Arranges for the provision of goods or services by another party	No	Yes
Does not have inventory risk before or after the customer orders goods, including the absence of risk related to product returns	No	Yes
Does not have discretion in establishing prices	No	Yes
The consideration paid to the selling entity is in the form of a commission	No	Yes
There is no exposure to credit risk that the customer will not pay	No	Yes

The differentiation between principal and agent is of some importance, for a principal recognizes the gross amount of a sale, while an agent only recognizes the fee or commission it earns in exchange for its participation in the transaction. This fee or commission may be the net amount remaining after the agent has paid the principal the amount billed for its goods or services provided to the customer.

In a situation where the seller is initially the principal in a transaction but then hands off the performance obligation to a third party, the seller should not recognize the revenue associated with the performance obligation. Instead, the seller may have assumed the role of an agent.

A sale may include a number of components. If so, the party selling the goods or services should determine whether it is the principal or the agent for each item promised to the customer. It is possible that the seller could be the principal for some items and an agent for others, which means that the accounting treatment will vary for each one, as noted earlier in this section.

Summary

An essential benefit of Topic 606 is that the recognition of revenue from contracts with customers is quite consistent across many types of contracts and industries. This is quite useful for the auditor, who can apply the general revenue rules noted in this chapter to the revenue transactions of most clients. The more specialized revenue rules noted later in this chapter are based on the same underlying principles upon which Topic 606 is based. This means that the correct accounting is based on when control passes to the customer, whether there is a separate performance obligation, and whether the performance obligation is completed as of a point in time or over time. In essence, the accounting standards have been formulated to adhere to the same principles in as many cases as possible, to prevent unorthodox accounting solutions.

Review Questions

4. The following is one of the conditions needed for a seller to recognize revenue under a bill and hold arrangement:
    a. The sale transaction must come through a third-party intermediary
    b. The goods must be physically segregated
    c. The product must be in its final stages of completion
    d. The seller must not be able to redirect the goods elsewhere

5. A consignment arrangement is likely to be present when:
    a. The goods are controlled by the customer
    b. The seller can require the intermediate party to redirect the goods
    c. The intermediate party must pay for the goods
    d. There is a financing element to the arrangement

6. The seller is more likely to be acting as an agent when:
    a. There is exposure to credit risk that the customer will not pay
    b. The seller has the ability to modify prices
    c. The seller arranges for the provision of goods or services by another party
    d. The seller controls the goods or services before transferring them to the customer

Answers to Review Questions

Chapter 1 – Auditing Revenue

1. The following is a valid characteristic of revenue:
    a. Billings for shipped goods may be missed
    b. There are few period-end cutoff concerns
    c. Complex transactions can be accounted for with little need for a supporting procedure
    d. The fraud risk associated with revenue is unusually low

    a. **Correct. It is quite possible that there will be a breakdown in the notification system between the shipping department and the accounting department, resulting in missed billings.**
    b. Incorrect. One of the easiest ways to inflate reported revenue levels is to keep the books open, so that shipments in the following period are recorded as sales in the prior period.
    c. Incorrect. Supporting procedures are useful for informing the accounting staff about how a deal with complex sales transactions, so that revenue recognition is accurate.
    d. Incorrect. Revenue is commonly manipulated when management wants to artificially alter the reported results of a business.

2. The risk of material misstatement can increase when:
    a. The client engages in bill and hold transactions
    b. The client periodically updates its product line
    c. The client requires its sales staff to follow standard contractual selling terms
    d. The client engages in cash sales and purchases

    a. **Correct. A client must follow specific rules for recognizing revenue under bill and hold arrangements. If it does not do so, it may be overstating revenue.**
    b. Incorrect. Sales of updated products are probably sold under the same standardized terms as the products they replace. The situation is different for entirely new products, which may have new selling terms associated with them.
    c. Incorrect. There is less risk of misstatement when selling terms are standardized. Conversely, the risk of misstatement increases when the sales staff is allowed to customize selling terms.
    d. Incorrect. Cash sales and purchases are easily tracked, with no risk of misstatement. The risk is much higher when the client engages in barter transactions.

3. The following activity is associated with the control environment of a business:
    a. Confirm special prices granted to customers
    b. Prenumber bills of lading
    c. Segregation of duties for shipping and billing
    d. Commit to providing adequate training for accounting personnel

    a. Incorrect. The confirmation of special prices is a verification control, to ensure that these prices are authorized.
    b. Incorrect. The pre-numbering of bills of lading is needed to ensure that the period-end cutoff is properly observed.
    c. Incorrect. The segregation of duties is an authorization control, to ensure that someone cannot create fake shipping documentation to support the recordation of a fake invoice.
    d. **Correct. A commitment to adequate training is essential to a control environment, so that personnel know when it is appropriate to bill customers.**

Chapter 2 – Revenue Rules

4. The following is one of the conditions needed for a seller to recognize revenue under a bill and hold arrangement:
    a. The sale transaction must come through a third-party intermediary
    b. The goods must be physically segregated
    c. The product must be in its final stages of completion
    d. The seller must not be able to redirect the goods elsewhere

    a. Incorrect. If there is an intermediary, there may be no way to determine the reason for the arrangement, which must be documented as part of the arrangement.
    b. Incorrect. It is not necessary to segregate goods under a bill and hold arrangement, though they must be identified as belonging to the customer.
    c. Incorrect. The goods must be ready for shipment; being almost ready implies that the seller has not fulfilled its performance obligation.
    d. **Correct. A requirement of a bill and hold arrangement is that the seller is not able to redirect the goods, either to a third party or to some other internal use.**

5. A consignment arrangement is likely to be present when:
    a. The goods are controlled by the customer
    b. The seller can require the intermediate party to redirect the goods
    c. The intermediate party must pay for the goods
    d. There is a financing element to the arrangement

    a. Incorrect. When the goods are controlled by the customer, there cannot be a consignment arrangement, since such an arrangement implies control by the seller.
    b. **Correct. When the seller can redirect goods, this is a strong indicator of seller control, which implies that a consignment arrangement exists.**
    c. Incorrect. An obligation by the intermediate party to pay for the goods implies that this party likely also controls the goods. If there is control, there is an implication that the intermediate party has the rights and obligations of ownership, and so is the owner of the goods.
    d. Incorrect. The existence of a financing arrangement is unrelated to the determination of a consignment arrangement; it merely indicates the presence of a loan arrangement.

6. The seller is more likely to be acting as an agent when:
    a. There is exposure to credit risk that the customer will not pay
    b. The seller has the ability to modify prices
    c. The seller arranges for the provision of goods or services by another party
    d. The seller controls the goods or services before transferring them to the customer

    a. Incorrect. Having exposure to credit risk is a sign that the seller is acting as the principal in a transaction.
    b. Incorrect. A principal has the ability to modify the prices of the goods or services that it sells.
    c. **Correct. An agent may arrange for the provision of goods or services by another party; it does not directly engage in these activities.**
    d. Incorrect. A principal in a transaction controls goods or services prior to transferring them to the customer; an agent does not.

Glossary

A

Analytical procedures. Procedures that involve comparisons of different sets of financial and operational information, to see if historical relationships are continuing forward into the period under review.

B

Bill and hold. An arrangement under which the seller does not ship goods to the customer, but still recognizes the related revenue.

Bill of lading. A document that states the type and quantity of goods being sent from a seller to a buyer. The document also details the method of shipment and how it will be routed.

C

Consignment. When the owner of goods leaves them with another party to be sold.

I

Inherent risk. The probability of loss based on the nature of an organization's business, without any changes to the existing environment.

M

Material misstatement. An error in the financial statements that can affect the economic decisions of the users of those statements.

R

Related party. An individual who occupies a managerial position within a business, or who is a family member of such an individual, or who can influence decisions made by the business.

Revenue. An increase in assets or decrease in liabilities caused by the provision of services or products to customers.

S

Sales allowance. A reduction in the price charged by a seller, due to a problem with the sold product or service, such as a quality problem, a short shipment, or an incorrect price.

Sales return. Merchandise sent back by a buyer to the seller.

Sales order. A document generated by a seller for its internal use in processing a customer order.

Segregation of duties. The assignment of various steps in a process to different parties.

Substantive procedures. Procedures that are performed by an auditor to detect whether there are any material misstatements in accounting transactions.

Index

Accelerated revenue recognition 4
Accounting policies, changes in 9
Accrued revenue 9
Agent versus principal 27
Analytical procedures 11
Audit objectives 1

Background research 1
Bill and hold 25
Bills of lading, unmatched 13
Business purpose of sales 9

Consignment arrangements 10
Consignments 26
Contracts, linkage to customers 17
Control environment 13
Customer acceptance 26
Customer billing statements 14
Customer contracts 9

Data validation, automated 13
Discount confirmation 13
Discount rate 20
Distinct criterion 18

False sales 4
Fraud schemes 4

Inherent risk 5
Input methods 24
Intercompany sales 10
Invoice error checking 13
Invoice funding verification 13
Invoice review 8

Multi-component sales 9

Noncash consideration 20
Nonrefundable upfront fees 26

Output methods 24

Performance obligations 17
Price allocations 21
Price changes, subsequent 22
Price discounts 22
Principal versus agent 27
Progress completion method 23
Progress measurement 24

Recordation review 8
Related parties 11
Residual approach 21
Revenue
  Account characteristics 2
  Accounts 2
  Characteristics of 2
  Controls 13
  Process flow 3
Revenue recognition
  Final step 23
  Steps 16
Revenue reversal 19
Right of return 25
Risk of material misstatement 5

Sales cutoff 7
Sales order, match to invoices 14
Sales returns allowance 10
Sales returns and allowances 3
Sales returns, review of 10
Segregation of duties 11, 14
Shipping document cancellation 11
Side agreements 11
Substantive procedures 6
Supporting documentation 8

Time value of money 20

Variable consideration 19, 22

Final Examination

The final examination for this course is provided below. Feel free to circle your choice for the best answer to each question. To enter your answers online and receive an immediate grade and completion certificate, follow these steps:

1. Go to www.accountingtools.com/cpe
2. Click on the "Access the Training Module | Complete a Test" button near the top of the page.
3. Login with your user name and password.
4. Select the **Take a Test** option and then select the **Programs** option. Click on the program that you want to take.
5. Take the test. You can stop and restart the test at any time.

---

1. The sales returns and allowances line item appears as a subtraction from the ___ line item in the income statement.
   a. Gross revenue
   b. Net revenue
   c. Cost of goods sold
   d. Operating expenses

2. The following actions can all result in the recordation of false sales, except for:
   a. Ship goods to another company location
   b. Ship goods to a recurring customer
   c. Ship goods under a consignment arrangement
   d. Ship goods that were not ordered by a customer

3. An auditor traces sales tickets to the sales journal. The auditor is:
   a. Looking for multi-component sales
   b. Verifying that sales tickets have been properly recorded
   c. Evaluating the business purpose of a sale
   d. Verifying that sales tickets have been correctly constructed

4. An auditor observes that there is a large initial entry to accounts receivable, followed by a series of smaller pay-down entries against the receivable. This is evidence of:
   a. An intercompany sale
   b. Accrued revenue
   c. A multi-component sale
   d. A consignment arrangement

5. A contract does not exist when:
   a. There is no signature on the document
   b. It is being combined with another contract for accounting purposes
   c. Each party has a unilateral right to terminate the agreement and without compensating the other party
   d. There has been no prior legal review of the contract terms

6. A good or service is considered to be distinct when:
    a. The customer separately pays for the item
    b. Delivery of the item is separately identified within the contract
    c. Functionality of the deliverable is not assured unless this item is delivered
    d. There is a standalone price for the item

7. The expected value method is used when:
    a. There are a large number of possible payment amounts
    b. The result must match one of the prices that could be paid
    c. The amount of consideration to be paid is fixed
    d. All performance obligations have been fulfilled

8. If the customer pays the seller with a noncash asset:
    a. Do not account for the receipt until the asset has been liquidated
    b. Use the residual method to determine its value
    c. There is no contract
    d. Measure the consideration at its fair value

9. The balance in a refund liability account is based on:
    a. The amount of consideration paid to customers
    b. The cost of goods sold reduction associated with expected returns
    c. The number of units that the seller expects to have returned to it
    d. The net amount of revenue apportioned to refunds

10. Under a customer acceptance clause, the seller can still recognize revenue prior to acceptance if:
    a. The seller pays the customer to skip the acceptance review
    b. There are no circumstances under which early recognition can be enacted
    c. It creates a sufficiently large reserve to offset any possible customer rejections
    d. The seller can determine in advance that the acceptance criteria will be met